



# 11 o'clock tips

## Simply Fiscal Policy

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The word fiscal refers to a government's finances: to government expenditures and government (tax) revenues

### **Government expenditures (G)**

Classified into:

- *Current* (e.g. salaries paid to public sector employees);
- *Capital* (public investment; e.g. spending on the construction of a bridge)
- *Transfer payments* (e.g. unemployment benefits or cash transfers to low income mothers; not part of GDP but part of disposable income)

### **Government revenues (T)**

Mostly originate from taxes; also from the sale to the private sector of state owned assets (privatization proceeds) or from any profits of state owned enterprises.

- If  $G > T$  then there is a *budget deficit*
- If  $T > G$  then there is a *budget surplus*

### **Note**

- Above should not be confused with a *current account deficit* or *surplus*; these refer to international trade and the relationship between export revenues (X) and import expenditures (M) on goods and services

## The public debt

- The sum of past deficits minus any budget surpluses; it refers to what a government owes.
- A budget deficit adds to the outstanding national debt.

## Fiscal policy

A demand side policy aiming at influencing aggregate demand and thus real output/ growth; the average price level/ inflation or deflation as well as employment/ unemployment (and, also, the size of a *current* account deficit or surplus)

### Expansionary Fiscal Policy

- *Goal*: to increase AD
- *Why?* To ‘reflate’ an economy (= to increase real output; to ‘lift an economy from recession’); to lower (cyclical) unemployment; to, perhaps, help an economy exit deflation by creating some inflation)
- *How?* Expansionary fiscal requires the government increasing G and/or decreasing T (deficit spending)

### The mechanics of expansionary fiscal policy:

- If  $G \uparrow \rightarrow AD \uparrow$  as G is a component (direct effect)
  - As a result of the *multiplier effect*<sup>1</sup>  $\rightarrow \Delta Y_r > \Delta G$
  - $AD \uparrow$  and shifts right (use a Keynesian AS curve)
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- If  $T \downarrow \rightarrow$  disposable income<sup>2</sup>  $\uparrow \rightarrow C \uparrow$ , a component of AD
  - $AD \uparrow$  and shifts right (use a Keynesian AS curve)

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<sup>1</sup> multiplier effect rests on the fact that one’s spending is someone else’s income and that economic activity takes place in successive rounds

<sup>2</sup> disposable income = income minus direct taxes plus transfer payments

### Note

- Effects of expansionary AD on  $Y_r$ , APL and employment depend on whether the increase is in section I or section II or section III of the Keynesian AS you have drawn. Draw and see for yourself.

### Note

- Expansionary fiscal policy closes a deflationary gap defined as the difference between equilibrium real output and full employment output when  $Y_e < Y_f$

### Contractionary Fiscal Policy

- *Goal:* to decrease AD
- *Why?* To 'cool off' an overheating economy e.g. to lower inflation (also, for later, to narrow a widening *current account* deficit)
- *How?* Contractionary fiscal requires the government decreasing G and/or increasing T

### The mechanics of contractionary fiscal policy:

- If  $G \downarrow \rightarrow$  AD decreases as G is a component (direct effect)  $\rightarrow$  inverse here *multiplier effect*  $\rightarrow$  the decrease in real output (Y) will be greater than the original decrease in G  $\rightarrow$  AD shifts left (use a Keynesian AS curve)
- If  $T \uparrow \rightarrow$  disposable income decreases ( $Y_d = Y - T + Tr$ )  $\rightarrow C \downarrow$ , a component of AD  $\rightarrow$  AD will  $\downarrow$  and shift left (use a Keynesian AS curve)

### Note

- Effects of contractionary AD on  $Y_r$ , APL and employment depend on whether the decrease is in section I or section II or section III of the Keynesian AS you have drawn. Draw and see for yourself.

## Note

- Contractionary fiscal policy closes an inflationary gap; if you have used a Monetarist AD/AS framework it is defined as the difference between equilibrium real output and potential output when  $Y_e > Y_p$ ; if you have drawn a stylized Keynesian '3 section' AS, then, *since the idea of the NRU is Monetarist and should thus, strictly speaking, not be included in a Keynesian 3 section AS diagram*, the closing of the inflationary gap must be the resulting decrease in APL on section III; see the '11 o' clock Simply Gaps' file)

## Fiscal policy can be discretionary or automatic

If the government changes the level of  $G$  and / or  $T$  then we have what is referred to as discretionary fiscal policy but the size of government expenditures or tax revenues may change without any government action: case of 'automatic stabilizers'

## The impact of Automatic Stabilizers (U benefits & progressive taxation)

Refer to the effect on real output (on economic activity) of unemployment benefits and of a progressive income tax system.

### What do these do?

- They mitigate the short term fluctuations of real output without direct government intervention → recessions are milder and booms less inflationary.

### How do they do it?

- In a recession → firms downsize and shut down → people lose their jobs → but their (disposable) incomes do not drop as much because unemployment benefits automatically kick-in → their spending thus does not drop as much

- AD decreases below but not much below original level → recession is milder; *also* → tax collections ↓ → so, part of the decline in real GDP is offset
- In a boom → spending and thus AD does not rise as fast → why? disposable incomes rise slower as progressive income taxes bite-off a proportionately bigger and bigger chunk → boom not as inflationary; *also* → fewer families eligible in a boom for government transfer payments.

### **Fiscal policy and its impact on potential output**

(Expansionary) fiscal policy will increase AD as explained but can also increase potential (full employment) output (i.e. shift to the right the Keynesian AS or the Monetarist vertical LRAS)

#### **How?**

- **Indirectly**

##### **What does this mean?**

- If fiscal policy is 'sound' → entrepreneurs (businesses) feel 'safer' → they will tend to invest more (build factories) → the 'stock of physical capital' of an economy increases → LRAS shifts right
- BTW, 'sound fiscal policy' is the opposite of what Greek governments did → 'sound' refers to running low budget deficits and consequently, a sustainable public debt → Entrepreneurs are not afraid of a sudden increase in taxes or in interest rates or in the money supply

- **Directly**

### **What does this mean?**

- Spending on education and health care services → economy's stock of 'human capital'<sup>3</sup>↑ → labor productivity↑ (as with same labor more output can be produced →  $Y_p$ ↑ → LRAS shifts right
- Spending on physical capital i.e. infrastructure<sup>4</sup> → more & better infrastructure (electricity grids, airports, harbors etc.) lowers the overall cost of economic activity →  $Y_p$ ↑ → LRAS shifts right
- Lower (direct) taxes → incentive to work and to invest↑  $Y_p$ ↑ → LRAS shifts right (note that effect of lower taxes is controversial → remember the Saez Berkeley lecture)

## **Evaluation of Fiscal Policy**

### **Advantages**

- Expansionary fiscal policy is direct (as  $G$  is a component of  $AD$ ) and thus more certain in its effects
- It is typically powerful to lift an economy out of recession as a result of the operation of the multiplier effect
- It can also have a positive long term effect on the LRAS if government spending targets education, health care, infrastructure
- Lower taxation may induce a positive supply-side effect by improving incentive to work / to invest

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<sup>3</sup> the education, training and skills embodied in the labor force

<sup>4</sup> spending typically by government on physical capital (roads, ports) that lower the overall cost of economic activity

## Disadvantages

- It has long time lags
- It is not easily reversible
- It cannot easily be incremental
- It suffers from an expansionary bias (more often expansionary than contractionary as a result of self-interest of politicians)
- Spending cuts and tax increases faces political constraints as both are unwelcome and unpopular
- Raising taxes may decrease incentive to work / to invest
- Expansionary fiscal may crowd-out private investment and consumption  
(*crowding out effect*: deficit spending requires financing → government borrows → demand for loanable funds↑ → interest rates↑ → C↓ and I↓ so AD does not rise as much as expected)
- Deficit spending increases public debt to potentially unsustainable levels
- Expansionary fiscal may prove inflationary and it may lead to a widening current account deficit